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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 3/15/84 **Number:** ---------- **Due By:**

Subject: Cabinet Council on Economic Affairs Minutes: February 21, 23, March 1, 2, and 6

	Action	FYI
ALL CABINET MEMBERS	☐	☑
Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☐	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☐	☑
CEQ	☐	☐
OSTP	☐	☐
Baker	☐	☑
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☐	☑
CCCT/Gunn	☐	☑
CCEA/Porter	☐	☑
CCFA/	☐	☑
CCHR/Simmons	☐	☑
CCLP/Uhlmann	☐	☑
CCMA/Bledsoe	☐	☑
CCNRE/	☐	☑

REMARKS:

Attached for your information are the minutes of the following CCEA meetings:

February 21
February 23
March 1
March 2
March 6

All domestic issues - e.g. tax policy, credit policy, youth unemployment, rural electrification, brokered deposits etc.

DCI EXEC REG

RETURN TO:

☐ Craig L. Fuller
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☐ Katherine Anderson
☑ Tom Gibson

☐ Don Clarey
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Associate Director
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MINUTES
CABINET COUNCIL ON ECONOMIC AFFAIRS

February 21, 1984
8:45 a.m.
Roosevelt Room

Attendees: The Vice President, Messrs. Regan, Block, Baldrige, Brock, Feldstein, Porter, Wright, Abrams, Ballentine, Chapoton, Ford, Jones, Coy, Gibson, Lindsey, Neal, Platt, and Li.

1. Report of the Working Group on Research and Development Tax Policy

Assistant Secretary of the Treasury Chapoton presented a report of the Working Group on Research and Development Tax Policy. The Senate Finance Subcommittee on Taxation and Debt Management is holding a hearing on February 24 to consider a bill sponsored by Senator Danforth that would make permanent the tax credit for research and experimental (R&E) expenses and modify the definition of qualified research for purposes of the credit.

The Working Group believes that the definition proposed in the Danforth legislation would be too broad since expenditures leading to any functional improvement of a product would qualify for the credit. The Working Group recommended that the definition be targeted more closely to truly innovative activities by considering whether the taxpayer faces substantial technological risk that the activity will not succeed. In the absence of technological risk, R&E activities would qualify for the credit if:

1. The taxpayer sought a significant functional improvement over the existing state-of-the-art;

2. The taxpayer sought a significant reduction in the cost of a process or a product;

3. The taxpayer's activity involved experimentation in the laboratory or scientific sense; or

4. The taxpayer's activity was designed to lead to a significant increase in the body of technological knowledge in an industry.

R&E activities would not qualify for the credit if:

1. The taxpayer's activity involved routine or cosmetic alterations to existing products;

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2. The predominant uncertainty in the success of the taxpayer's activity relates to the existence of or possible changes in market conditions;

3. The taxpayer's activity was primarily intended to replicate existing products produced by others; or

4. The taxpayer's activity was designed to combine existing items whose capabilities were known.

The Council reviewed the evidence concerning the effectiveness of the credit, concluding that more time is needed to evaluate its effectiveness. The Council agreed to support a five-year extension of the credit to provide industry sufficient certainty to develop research and development plans and more time to determine whether the credit has stimulated additional investment in R&E. The Department of the Treasury has testified earlier in support of a three-year extension.

The Council discussed the differences between the definition of R&E used by the Financial Accounting Standards Board (FASB) and that proposed by the Working Group. Council members agreed that while the Working Group definition would be difficult to administer, particularly for Internal Revenue Service agents in the field, it would have the advantage of better targeting more significant innovative activities. The Council noted that the tax code already allows a full deduction for research research and development expenditures. The ERTA credit is in addition to the regular deduction. Several members argued that to stimulate more significant innovation, the Federal Government should use a narrower definition for the ERTA credit.

Some members expressed concern about the emphasis of the Working Group definition on technological risk. Not only would it be more difficult for larger companies than for smaller companies to demonstrate technological risk, risk per se is not related to the existence of an externality, which should be the justification for government subsidization of R&E activity.

Mr. Chapoton will compare the FASB definition with the Working Group definition.

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MINUTES
CABINET COUNCIL ON ECONOMIC AFFAIRS

February 23, 1984
8:45 a.m.
Roosevelt Room

Attendees: Messrs. Regan, Block, Brock, Feldstein, Porter, Wright, Abrams, Ballentine, Brown, Carter, Ford, Knapp, Pearlman, Gibson, Neal, Platt and McAllister, Ms. Whittlesey, and Ms. Risque.

1. Report of the Working Group on Federal Credit Policy

Secretary Regan stated that the Cabinet Council had several decisions to make regarding a trusts for investments in mortgages (TIMs) tax proposal, including whether the Administration should propose legislation; and if so, how should the government sponsored agencies be treated? He noted that Senator Garn stated to him that the TIMs legislation is still timely and that the Senate Banking Committee is expecting an Administration proposal.

Mr. Ballentine, presenting the report of the Working Group, stated that at its November 1, 1983 meeting the Cabinet Council approved in concept a TIMs proposal intended to encourage the development of a private secondary mortgage market. At that time the Council decided to exclude the government sponsored agencies from directly issuing TIMs-like instruments or allowing agency securities to be used as collateral for private TIMs instruments. The restrictions were intended to offset the advantages inherent in FNMA's and FHLMC's perceived Federal Government agency status and permit the private sector to grow. He noted that the Cabinet Council decided against linking TIMs with specific steps toward privatization.

Mr. Ballentine stated that there are two distinct perspectives regarding TIMs legislation: a Federal credit policy perspective and a housing perspective. The credit policy goals of reducing Federal activities and encouraging the development of the private sector create some uncertainty within the housing industry regarding future sources of credit and thus a reluctance to accept change. He explained that the builder bond issue is a good example of these conflicting perspectives. Builder bonds are bonds issued by builders' financial subsidiaries and collateralized by mortgages on homes the builder has sold. The bonds allow builders to obtain the cash from a home sale through the bond backed by the home mortgage while deferring the income tax on the home sale. The Treasury draft TIMs legislation would prohibit the use of GNMA, FNMA or FHLMC securities as collateral for builder bonds, restricting the usefulness of builder bonds.

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The Working Group prepared four options for the Cabinet Council's review:

1. Deny TIMs-like arrangements for builder bonds if agency securities are used as collateral;

2. Allow agency securities to be used as collateral in a single class builder bonds that involve active management of prepayment but do not allow multiple classes of builder bonds with agency securities as collateral;

3. Allow the TIMs advantages to builder bonds backed by GNMA securities but only allow single class builder bonds if backed by FNMA or FHLMC securities; or

4. Allow full TIMs advantages for agency-backed builder bonds.

Mr. Ballentine explained that the Working Group had been meeting with groups that would be affected by the Treasury draft proposal. The Senate Banking Committee staff suggested changing the effective date from date of introduction to date of enactment. The Federal Home Loan Bank Board expressed support for limiting collateralized mortgage obligations (CMO's) and the representatives of the building industry expressed concern about uncertainty created by the changes and asked for further study of the bill's effect on the secondary mortgage market.

Mr. Knapp suggested that the Administration forward TIMs legislation permitting FNMA to directly issue TIMs instruments. Although the value of TIMs to homebuilders may have been eclipsed by the market, TIMs would serve as a useful portfolio management device for FNMA and thrift institutions. He also suggested that GNMA, FNMA and FHLMC securities be allowed as security for multiple class builder bonds. In his view excluding FNMA and FHLMC would provide cost savings to holders of mortgages with values greater than $114,000 but not below.

Mr. Abrams noted that the TIMs proposal was first suggested by the President's Commission on Housing as a device to improve the efficiency of the secondary mortgage market. With the restrictions in the Treasury draft legislation, TIMs would be viewed as an anti-housing initiative. He also noted that FNMA has a portfolio of $76 billion with an average return of 8.5 to 9 percent. TIMs could serve as a vehicle for reducing the "underwater" portfolio. He noted that it is likely that the TIMs proposal will be linked with S. 2040 and H.R. 4557, Administration supported legislation to strengthen the private secondary mortgage market. A restrictive TIMs proposal could jeopardize that legislation.

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Mr. Pearlman explained that the installment sales tax treatment of builder bonds is a growing problem. Through the installment sales tax treatment, builders can obtain significant amounts of profits, and not only avoid tax liability but incur tax losses. He noted that the problem of installment sales treatment is not confined to builder bonds, although the explosion of builder bonds is of particular concern. He explained that the Treasury draft TIM's legislation does not address the installment sales tax treatment of TIM's.

The Council's discussion focused on a number of issues, including whether the benefits of builder bonds are being passed on to homebuyers and the potential greater flow of investment to the housing sector at the expense of the business investment through an expansive TIMs proposal.

A majority of Cabinet Council members supported: (1) proposing TIMs legislation; (2) allowing agency securities to serve as collateral; (3) not permittting FNMA or FHLMC to directly issue TIMs; and (4) allowing GNMA securities to back multiple class builder bonds, but restrict FNMA and FHLMC securities to single class builder bonds.

Secretary Regan also asked that the Cabinet Council study the issue of savings, determining the growth of savings since 1981 and suggesting additional policies that would induce more savings.

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MINUTES
CABINET COUNCIL ON ECONOMIC AFFAIRS

March 1, 1984
2:00 p.m.
Cabinet Room

Attendees: The President, the Vice President, Messrs: Regan, Baldrige, Donovan, Hodel, Bell, Brock, Feldstein, Porter, Fuller, Wright, Abrams, Cogan, Lyng, Naylor, Taft, Baroody, Gibson, Platt, and McAllister, Ms. Dole, and Ms. Risque.

1. Youth Unemployment

Secretary Regan reported that as part of the economic policy study on reaching full employment, the Cabinet Council on Economic Affairs had focused on youth unemployment, which is a major part of the structural unemployment problem. In 1982, the Cabinet Council reviewed a wide range of proposals designed to address the problem of structural unemployment. The President approved a number of these proposals, combined them into a single package and submitted this package to the Congress as the Employment Act of 1983. A major element of this package that was not enacted was the youth employment opportunity wage. Secretary Regan reported that the Council is convinced that establishing a youth employment opportunity wage would be the single most valuable action the Government could take to increase youth employment. He noted that there is substantial public support for such a wage. The National Conference of Black Mayors, headed by Johnny Ford of Tuskegee Alabama, supports in principle the establishment of a differential minimum wage for youth.

Secretary Donovan stated that unemployment among minority youth is approximately 47 percent, despite the over $50 billion spent by the Comprehensive Employment and Training Act (CETA)in the past decade. He noted that the Administration's reform of CETA, enacted in the Job Training Partnership Act (JTPA) is going very well. A proposal to establish a year round youth differential minimum wage lost in the House of Representatives by a single vote in 1978. The President's proposal would be only for the summer months and is structured to mitigate concerns about possible displacement of older workers. He noted that some business groups oppose the youth differential because they fear it might lead to an increase in the general minimum wage. The Department of Labor estimates that a youth opportunity wage of $2.50 would create 150,000 to 650,000 jobs. He observed the opportunity wage is not the complete answer to youth unemployment, but it is an important tool. He stated that the youth opportunity wage needs strong Presidential backing and White House involvement if it is to be enacted.

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The President stated that historically as the minimum wage increased, youth employment decreased.

Decision

The President reaffirmed his support for establishing a youth employment opportunity wage and making a major effort to enact this legislation as a concrete step in reducing youth unemployment.

2. School-to-Work Transition Proposal

Secretary Donovan stated that Governor du Pont, Chairman of the Jobs for America's Graduates (JAG) program has asked the Administration to propose legislation funding a school-to-work transition program. JAG is an outgrowth of a program conceived by Governor du Pont in 1978 as a means of addressing high unemployment among workers under age 24 in his State. The JAG program provides in-school counseling for high school students not continuing their education.

Secretary Donovan stated that the Cabinet Council has prepared four options for the President's consideration regarding school-to-work transition program funding:

A. Propose or support separate legislation to authorize a national school-to-work transition program at $300 million in fiscal year 1985, escalating to $1 billion in fiscal year 1988. Secretary Donovan noted that such a program was not only a substantial new spending initiative at a time of budget restraint but that it would represent a return to the categorical programs that characterized the unsuccessful past Federal employment and training efforts.

B. Propose a $25 million to $50 million increase in the Department of Labor discretionary funds to support JAG demonstration projects in each of the 50 States. Secretary Donovan noted that the States already have $75 million in discretionary funds to establish their own demonstration projects. Providing earmarked Federal funds would be a form of categorical grant.

C. Propose an amendment reprogramming $25 million to $50 million from the Summer Youth Employment program to the JTPA discretionary account to fund an expanded series of school-to-work transition projects modeled after the JAG program. Secretary Donovan explained that this proposal would involve transfering funds away from the most disadvantaged served by the summer youth program to a program that serves both disadvantaged and non-disadvantaged youth.

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D. Do not propose legislation reprogramming funds toward school-to-work transition programs. Instead encourage States and localities to use existing authority and flexibility to establish school-to-work programs modeled after JAG. Secretary Donovan explained that this option continues to rely on the States and localities to use existing authority and flexibility under the JTPA, the Wagner-Peyser Act, Chapter II of the Education Consolidation Improvement Act, and the Vocational Education Act for implementing programs that meet their most pressing labor market problems.

Mr. Wright explained that in 1972 President Nixon combined a number of categorical training grants into the Comprehensive Employment Training Act. However, CETA quickly evolved into categorical grants, defeating its purpose. He expressed a fear that adding specific purposes and funding would lead to the categorization of the JPTA.

Secretary Bell, noting that the President's 1985 budget proposes a $250 million increase in the education block grant funding, stated that the States have the discretion to use these funds to school-to-work transition programs. He stated that he was not in favor of creating a new categorical program.

<u>Decision</u>

The President decided that the Administration would support option 4, not proposing legislation reprogramming funds towards school-to-work transition programs, while encouraging States and localities to use existing authority and flexibility to establish school-to-work transition programs modeled after JAG.

3. <u>Proposed Rural Electrification Administration (REA) Legislation</u>

Secretary Regan stated that the Rural Electrification Revolving Fund Self-Sufficiency Act, a bill promoted by the powerful National Rural Electrification Cooperative Association (NRECA), violates the Administration's principles of controlling federal credit activities and resisting special interest bailout legislation. The bill would cost the Federal Government $20.7 billion, including $8 billion in forgiveness of debt owed the Treasury. Other provisions of the bill include authorizing the REA to refinance outstanding loans whenever interest rates on those loans are at least 1 percent above the Treasury rate and effectively requiring a downward adjustment of interest rates on new REA loans when Treasury borrowing rates decline, but not requiring an upward adjustment when rates increase.

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Secretary Regan explained that last fall the Cabinet Council decided that the Administration should propose its own counter legislation regarding the REA. USDA has prepared such legislation, which would: (1) place REA activities on budget; (2) raise the REA lending rate equal to the Treasury's cost of money; and (3) require all borrowers to pay user fees to cover the costs of administering the loan. There is however little Congressional interest in pursuing the Administration's proposal or a similar proposal introduced by Representative Ed Bethune. He noted that Secretary Block, David Stockman and he had sent separate letters to the Congress indicating the Administration's opposition to the bailout bill. However, the House probably will pass the legislation this afternoon.

He stated that Secretary Block, who was unable to attend because he is testifying before Congress, believes that the most effective strategy might be to secure an agreement with Senator Baker that he would prevent the legislation from reaching the Senate floor.

Mr. Lyng stated that the legislation is far too costly. He observed however that the NRECA is a potent political force, with its members generally supportive of the Administration. Secretary Hodel noted that rural electrification is a high priority in the West, and that electricity is more costly in rural areas. He cautioned that any veto statement would have to be very carefully crafted.

Decision

The President approved the unanimous Cabinet Council recommendation that the Administration continue to support our legislation proposal while strongly opposing the NRECA bailout bill and evidencing no interest in negotiating a compromise on it.

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MINUTES
CABINET COUNCIL ON ECONOMIC AFFAIRS

March 2, 1984
8:45 a.m.
Roosevelt Room

Attendees: Messrs. Svahn, Feldstein, Porter, Wright, McNamar, Ballentine, Ford, Healey, Baroody, Cicconi, Gibson, Neal, Platt, and McAllister, and Ms. McLaughlin.

1. Brokered Deposits

Mr. Svahn stated that the purpose of the meeting was to review the status of the Federal Deposit Insurance Corporation's (FDIC) and the Federal Home Loan Bank Board's (FHLBB) proposed regulation limiting the use of brokered deposits. A decision on an Administration position was not necessary. He noted that Secretary Regan had excused himself from the brokered deposit issue because of his previous association with Merrill Lynch.

Mr. Healey reported that two months ago the FDIC and FHLBB offered for public comment a rule that would limit insured brokered deposits to $100,000 per broker. The purpose of the proposed regulation is to limit the coverage of Federal deposit insurance. Because the FDIC and FHLBB are independent agencies the Administration can only offer comments on the rule.

Mr. Healey stated that brokered deposits are a very small portion, roughly 1.2 percent, of total insured deposits. Brokered deposits offer a number of benefits including: (1) markets are made more efficient; (2) consumers are offered a wider range of maturities and terms; and (3) medium and small depository institutions that have outstripped their deposit base are able to continue to grow. He explained that the FDIC and the FHLBB are concerned that brokered deposits: (1) permit the expansion of weak or troubled institutions; and (2) expand the coverage of Federal deposit insurance beyond its intended purpose.

Mr. Healey stated that there are alternatives to the proposed regulation for controlling the access of weak or troubled institutions to brokered deposits. Both the FDIC and the FHLBB have developed an improved system of surveillance which permits them to better identify and regulate weak institutions utilizing brokered deposits. As of September 30, 1983, all Federally insured institutions are required to report the volume of their brokered deposits on a regular basis. In addition all problem institutions wishing to utilize brokered deposits in excess of five percent of their deposit base must receive regulatory approval or provide much more detailed reporting.

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The Working Group on Financial Institution Reform would prefer that the deposit institution regulators rely on supervisory tools, rather than the proposed rule to control problem institutions. The Working Group is concerned that the proposed rule can be evaded easily, while reducing the efficiency of the financial system. In addition the Working Group believes that brokered deposits are only a small part of the question; the rationality of the entire deposit insurance system needs to be reviewed.

Mr. Healey stated that the Working Group recommends not implementing the regulation. If the FDIC and FHLBB believe very strongly that a regulation must be implemented, alternatives such as a cap on the amount of brokered deposits all institutions can receive or a limit of a $100,000 insured deposit per broker per customer would be preferable.

The Council discussed a number of issues, including the ability of the market to evade the rule, the expansion of Federal deposit insurance beyond its original purpose, the Federal Reserve Board's concerns, and the importance of working with the FDICA and the FHLBB.

The Council decided that a small group of Administration representatives would meet with Chairman Issac and Gray to: (1) seek an extension of the comment period beyond March 8; and (2) better understand their concerns and attempt to develop a mutually satisfactory approach.

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MINUTES
CABINET COUNCIL ON ECONOMIC AFFARIS

March 6, 1984
9:45 a.m.
248 OEOB

Attendees: Messrs. Regan, Baldrige, Stockman, Feldstein, Darman, Abrams, Ballentine, Benjamin, Burnley, Lighthizer, Lyng, Poole, Sprinkel, Wright, Fitzwater, Gibson, McAllister, McMinn, Neal, Rhodes, and Li, and Ms. McLaughlin.

1. Financial Market Developments

Mr. Poole, reviewing Federal Reserve operating policies, stated that the Federal Reserve cannot simultaneously control interest rates and the money supply. Until October 1979, the Federal Reserve controlled the federal funds rate and allowed money supply growth to fluctuate. Between October 1979 and the summer of 1982, the Federal Reserve reversed its approach, targeting money supply growth and allowing the federal funds rate to fluctuate. Since the summer of 1982, the Federal Reserve has reverted to the earlier approach of targeting interest rates. The Federal Reserve is particularly sensitive to charges that it is pegging interest rates. There are several legislative proposals that would require the Federal Reserve to fix interest rates. The Federal Reserve strongly opposes such legislation because it would restrain its flexibility.

Mr. Poole stated that as a consequence of the Federal Reserve targeting interest rates, the money supply growth is dominated by shifts in demand. Mr. Poole supported his argument that the Federal Reserve is pegging interest rates by comparing gross and net Federal Reserve open market transactions. In November 1983, the Fed purchased $63.5 billion of securities and sold $60.3 billion, resulting in a net increase of its holdings of securities of only $3.3 billion. The large volume of transactions by the Federal Reserve could only have one purpose -- to adjust the supply of funds as necessary to keep changes in the demand for funds from affecting the federal funds rate to any significant extent.

Mr. Ballentine presented a paper reviewing recent stock and bond market developments. As of March 1, the Dow Jones Industrials Index is about 10 percent below the 1984 high to date (January 6.) Other indices have shown a similar decline. While this downturn is a reason for concern, it is important to remember that although recessions are typically preceded by declines in the stock market, declines in the stock market do not necessarily portend recessions.

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Mr. Ballentine argued that the recent downturn in the stock market could be attributed more to the long-term increase (since August 1983) in bond yields relative to dividend yields, than to the movement in interest rates over the last two months. Since Wall Street expected large Federal budget deficits, Administration testimony on the size of the deficits probably was not the cause of the decline in the stock market in recent months. However, factors such as the release of the minutes of the December Federal Reserve Open Market Committee meeting, presentation of the revised 1983 money supply figures, and the growing uncertainty over a policy deadlock on the budget may have contributed to the movements in stock prices and interest rates.

Mr. Sprinkel reviewed recent monetary developments. The recent 7 to 8 percent rate of growth in M1 and the revised 1983 money growth rates have reduced fears that deceleration of money growth will lead to a slowdown in the economy. However, the continued emphasis of the Federal Reserve on targeting the federal funds rate, rather than the money supply, implies continued unstable and unpredictable money growth. This increased uncertainty adds a risk premium to the level of interest rates.

Mr. Sprinkel stated that monetary policy is based largely on reaction to past economic developments. Such an approach can be risky because: 1) the data indicating recent economic developments are usually lagged and often revised later; and 2) if the Fed takes actions in response to these developments, its own actions affect the market with a lag of six to nine months. Thus, the actions the Fed takes may affect the economy in conditions far different from those existing at the time the Fed took the action.

Mr. Sprinkel emphasized the importance of Administration officials affirming our commitment to a noninflationary monetary policy.

The Council discussed the implications of the Federal Reserve maintaining the current monetary supply growth rates. Several members expressed concern that an annual M1 growth rate of over 8 percent would signal to the markets that the Federal Reserve is not committed to an anti-inflationary policy.

Secretary Baldrige expressed concern regarding possible Federal Reserve reactions to announcements of the economic growth rates in the first and second quarters of this year. Announcement of a strong growth rate in the first quarter due to pent-up demand could lead the Fed to raise the federal funds rate. A lower growth rate in the second quarter could lead to an abrupt and costly reversal of Federal Reserve policy.

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2. Status of the Dollar

Secretary Regan reviewed recent movements of the value of the U.S. dollar and changes in U.S. interest rates. From January 10 to March 5, the rate for certificates of deposit rose from 9.4 percent to 9.7 percent yet the U.S. dollar declined against the German mark and 5 percent against the Japanese yen. He noted that these developments suggest that high interest rates are not the primary cause of the high value of the dollar.

The Council discussed the effect of a decline in the value of the U.S. dollar on the merchandise trade account and capital flows. Secretary Regan requested that an analysis be conducted on the lag between changes in the U.S. dollar and its effect on the merchandise trade account.

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